

# LEVERAGE CROSS – BORDER LEASING

Indah Mula

## **Abstract:**

***Leverage Cross-border Leasing adalah suatu struktur sewa guna usaha berjenis leverage yang melibatkan pihak lessor dan lessee dari negara yang berbeda dan menganut hukum yang berbeda pula. Artikel ini mendeskripsikan leverage cross-border leasing, keunggulan dan resiko dari yang diperoleh masing-masing pihak cross-border leasing. Uraian mengenai "Double Dip" akan dijabarkan diakhir tulisan.***

## **Introduction**

Leasing has generated a great deal of interest in the financial institutions and among government officials as an effective financial instrument to facilitate economic development throughout the world. Before 1960's, leasing in many countries was confined to the short term renting of vehicles, equipment or building. Over than 25 years leasing of equipment has become a popular method of financing equipment worldwide.

Leases can be broadly classified as either operating leases or financial leases. Within these board classes, several types of lease contract can also be identified. One of the lease types is leveraged leasing, where a lessor can absorb the full benefits of tax deductions resulting from the ownership of the assets. The term "leveraged lease" is used to denote a lease in which the lessor borrows to fund the purchase of the equipment which is to be leased.

With the globalization, leasing is not only using between two companies in one country, but also widely use in different countries, called by cross-border leasing. Cross-border leasing is a new form of leased finance to leased assets or equipment with international market size, generally aircraft, ships or railway. A survey in US showed that American lessors finance US\$ 8-10 billion of equipment outside the United States during 1983 (Clark, 1985).

This paper is intended to explain the definition of Leveraged Cross-border Equipment leasing includes its mechanism. Another context to elaborate the advantages and disadvantages of this structure of each participants, they are the lessor, the lender and the lessee. The next context will describe very briefly about double dip. Finally, a conclusion will be provided at this end of paper.

## ***What is Leveraged Cross-border Equipment Leasing?***

The definition of leveraged cross-border equipment leasing can be divided into two sections that are "Leveraged Lease" and "Cross-border Lease". First, a leveraged lease is a lease where the lessor uses a specific borrowing, generally non-recourse, to help finance the acquisition of the lease equipment. (Skully, 1990). Second, cross-border lease is a mechanism to lease of equipment or assets between entities in different jurisdiction. For instance, a leasing between an American as a lessor and an Australian as a lessee.

Thus, the definition of Leveraged Cross-border Equipment leasing is a leveraged lease structure that the lessor and the lessee come from different jurisdiction to lease equipment. Furthermore, the main criterion of a cross-border leasing transaction is that the lessor and lessee must reside in different countries and hence the lease crosses at lease one national border.

An American leasing company undertook the first transaction of this cross-border leasing in the 1960's (Skully, 1990). Via cross-border leasing, various types of equipment manufactured in the US were transferred to other countries under this scheme. On viewing the benefits derived by the American lessor with regard to claim accelerated depreciation and obtain investment tax benefits, moreover, decreasing the cost of cross-border leasing transactions for non-resident lessees. Despite of those benefits, this form of leasing became popular and widely adopted in British and European. Presently, it has gained wide popularity in Asia also.

Essentially, there are two types of cross-border lease transactions:

- ❖ True funding – where the end-user of the equipment pays lease rentals over time. The transaction benefit is usually derived as a cost of funds saving.
- ❖ Defeased – where the end-user of the equipment is released from the future obligations by either making an up-front prepayment and/or making an appropriate investment to cover these future obligations. The transaction benefit is usually obtained as an upfront net present value.

The mechanism of leveraged cross-border leasing can be explained with the diagram base on Figure 1.

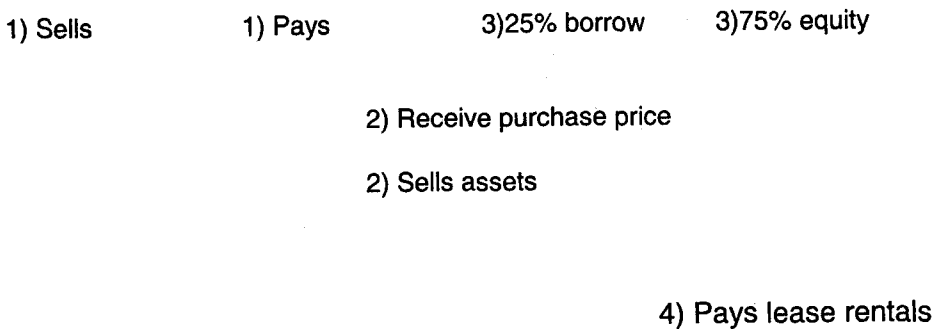


Figure 1: Leveraged Cross-border Equipment Lease Structure

The following steps explain the entire leveraged cross-border sale and lease back transaction.

1. The lessee (who resides in the US) uses his funds and loans obtained from various sources to purchase the asset from the manufacturer.
2. Next, the lessee sells the asset to the lessor at the face value of the equipment
3. The lessor (who resides in the Japan) obtains the finance for the purchase of the asset from two sources: from the lender, typically insurance companies, pension funds, trusts and banks, to extent of approximately 75% of the cost of the asset. Lessor invests his own equity which is roughly 25% of the cost of the asset.

The loan from the lender can be treated as non-recourse loan where the lender has no-recourse to the lessor, but retains direct recourse to either the lessee or the leased equipment.

4. Finally, the lessor and the lessee then enter into a lease contract transaction between parties. The balance amount received from the lessor as per step 2 is invested in a bank account, which acts as a "defease" for the lease contract.

Under a defeased structure, the lease payments are then disbursed from the bank accounts holding the balance of the funds initially paid by the lessor to the Japanese lenders. A defeasance transaction reduces an entity's overall liabilities through the effective cancellation of some of its existing debt or other obligations. In the context of cross-border leasing it involves the transfer of the lessee's lease payment obligations to a financial institution.

### *Advantages of leveraged cross-border leasing to participants*

This structure, leveraged cross-border equipment leasing, has many advantages for its participants. The advantages can be elaborated into three parts based on the participants, which are:

- *The Lessor*
- *The Lender*
- *The Lessee*

### **Advantages for Lessor**

#### *Tax benefit*

Tax incentives are obtained by the lessor, from the ownership of the equipment in the form of depreciation, investment allowance, interest on borrowed monies and repairs and maintenance (Bamberger, 1999). The lessor provides only a part of funds from its own resources for the purchase of the equipment, borrowing the remainder from lenders (financial institutions) on a non-recourse basis. The lessor is therefore at risk for only a portion of the cost of the equipment and yet claims tax benefits based on the whole of the cost. Countries where tax owner of the asset is determined by legal ownership include France, Sweden, Switzerland and the United Kingdom (Clark, 1985)

#### *Tax indemnification*

Lease agreements generally provide tax indemnity for lessor in order to cover the possibility loss by the lessor of the income tax benefits that the lessor expects to receive. This indemnity is obviously required because such benefits (investment allowance, depreciation, interest, management fees) are taken into account in calculating the rental structure under the leverage lease.

### *Non-recourse loan*

Based on non-recourse loan, the lessor has no obligation or repayment responsibility to the lender when the lessee fails to meet its obligation (Contino, 1997). In simple way, repayment is not the responsibility of the lessor, the lender can only look to the lessee, the cash flows of rental payments and the leased equipment for repayment have been assigned to the lender.

### *Repossession*

As part of the default procedure, the lessor becomes entitled to recover possession of the asset, and at this point the lessee's obligations relating to redelivery the equipment or asset. In fact, in many countries, the lessor is, in law, an owner and not merely a secured lender. (Bamberger, 1999)

### *Benefit from defeasance payment by lessee*

With defeasance payment, lessee buy securities in two currencies (currency of lessor and lessee) which this payment could minimize exchange rate risk to lessor during lease period in case the currency of lessor is depreciated. The defeasance payment (paying a large amount of money equal to present value of lease payment obligation) is for high credit rating of lessee where this could be an effective reference for lessor to generate loan from many banks. (Couderts Brothers, 1997).

### *Foreign denominated revenue*

The increased competition in cross-border leasing is the willingness of lessor to dominate their equity contribution and repayment in foreign currencies. This is usually because the rates of return are higher in that foreign currency and also because the transaction's benefit are more tax timing than from cash flow in net present value terms.

### *International market*

The lessor has widely access to cross country to sell the leased equipment and the opportunity for the market value will be higher than the residual value.

## **Advantages for Lender**

### *Benefit over lessor*

The lender will be entitled to the benefit of the lease agreement in the event of default by the lessee. In other word, the lender has higher legal priority than the lessor in case of lessee default. (Bloomer, 1999) Normally, the lender takes charge over the asset and the lessor's rights under the lease, particularly the right to receive the rentals especially where the asset

has little market value and the right to lean asset. (Schtelmakh, 1999).

### ***Benefit of defeasance payment***

Because of full-payout net lease from lessee in defeasance payment, lease payments are disbursed from the bank account to lender. Thus, the lender is confidentially able to rely on the creditworthiness of lessee without various risks relevance to leases (Bloomer, 1999)

## **Advantages for Lessee**

### ***Tax Benefit***

The lessee remained entitled to the tax depreciation and other tax incentives in their own countries, while enjoying reduces rentals fee arising from the export of tax benefits from the lessor's country to the country of the lessee.

The countries which treat the lessee as the owner of leased equipment for tax purposes and thus entitled to tax depreciation or credits if it has economic ownership of the asset include Australia, Germany, Japan, the Netherlands and the United States (Clark, 1985).

### ***Low financing cost***

Cross-border transactions provide an upfront cash benefit or a lower overall effective funding cost to lessees. The lessor share their tax benefit with the lessee by means of lower lease payments and the lessee get the benefit of low interest rate on the loan obtained in the lessor's country. These reduce the financing cost of the lease for the lessee. In the most cases, US-Cross-Border Leasing allows for a net cash advantage of 3%-6% of the leased object's assessed value.

### ***Preservation of alternative sources of finance***

By using cross-border leasing scheme, it is unnecessary for companies to spend large part of their own equity or raise money from debt holder to invest into a project that can possibly put in the lease agreement. Thus, lessee could spend their fund to another project which has high profitability.

### ***Benefit of defeasance payment in Cross-border leasing***

Defeasance of lease payments through the deposit arrangements permits the transit system to minimize its currency and interest rate risk exposure. Currency swap arrangements are made at the time of closing to protect the lessee from foreign currency fluctuations. In defeased transaction, the "spread" between the cost of funds borrowed by the lessor and interest earned by the deposit made by lessee is kept through investment agreement. The investor agreements protect the lessee from the risk of interest fluctuation over the term of the lease.

## ***Disadvantaged of leveraged cross-border leasing to participants***

Leveraged cross-border equipment leasing has shown a significant growth which gives a lot of advantages especially in tax. However, there are also some disadvantages from this cross-border leasing based on its relationship between participants.

The advantages can be divided into three parts too. They are:

- *The Lessor*
- *The Lender*
- *The Lessee*

### **Disadvantages for Lessor**

#### ***Different Jurisdiction Risk***

By definition a cross-border leasing transaction involves two parties are residents of different jurisdictions with different legal systems. Therefore, this leasing transaction must at the same time meet the legal requirements of both jurisdictions. It is highly recommended for the lessor to carefully understand the law of the lessee's country especially the laws regulating the repossession of leased equipment in the event the lessee's default its obligation under cross-border leasing transaction. It is also important to understand the local regulation about the bankruptcy or insolvency of a company.

#### ***Credit Risk***

Another problem should be faced by lessor is the credit risk in the lessee's jurisdiction which refers to debt-equity ratio where the ratio in developing countries is much higher than in developed countries. Furthermore, it is difficult for the lessor to obtain information related to the activities of lessee.

#### ***Political Risk***

Political risk includes the risk of expropriation, nationalization, interference of state government to the project and political instability.

#### ***Currency Risk***

In generally, leasing payment is in hard currencies, such as, US Dollar, Pound Sterling, German Mark. It is impossible to cover the whole contracts with SWAP contract in order to avoid the exposure of currency risk especially in developing countries.

### ***Force Majeure Risk***

Force majeure literally refers to circumstances that cannot control by the lessee or the lender. These typically include such as nature disaster, for example earthquakes, floods etc as well as man disaster such as war and terrorism.

### ***Lessee bankruptcy***

The lessee may default before the investment is recovered, in which case the lender has first call on available funds base on the non-recourse loan.

### **Disadvantages for Lender**

#### ***Lessee bankruptcy***

Different jurisdiction may be a problem for the lender if the lessee goes bankrupt especially about the repossess lease equipment. Moreover, the lender cannot ask responsibility to the lessor based on a non-recourse loan.

### **Disadvantages for Lessee**

#### ***Replacement of Parts***

The lessee wishes to retain the right to substitute or upgrade components of the assets to maximize its operating capabilities in the light of current technological development. It may be difficult for the lessee, who will replace parts as and when essential to keep the leased property operational (Bloomer, 1999).

#### ***Maintenance and Repair***

Lessor will provide maintenance and repair for lessee who with weak reputation or credit rating. Moreover, the lessee is also need to contribute to the preserve the capability of the equipment. (Bloomer, 1999)

#### ***Lease termination***

Leases might be terminated upon default by the lessee and the damage of equipment. Due to this termination, the lessee will have obligation to make stipulated loss to the lessor. (Transit Cooperative Research Program, 1999)



### ***Lessor bankruptcy***

Bankruptcy of the lessor raises the risk that the lender will take over the lease as a real lease and take control of the equipment from the advantage of the lessor's bankruptcy. (Transit Cooperative Research Program, 1999)

### ***Defeasance bank bankruptcy***

If the defeasance bank unfilled its obligation, the lessee will take the responsibility for the payment (assumed as the defeasance bank) to the lender.

### ***Double Dip taxation advantage***

For tax purposes, every country has its own methods for identifying the owner of leased assets in a leasing transaction. The owner of such assets uses depreciation which occurs from the owned to decrease its taxation bases.

According to Schtelmakh, an economist with the Leasing Development Group, cross-border leasing transaction will be highly profitable may be concluded among residents of countries which apply different methods of identifying the party on whose balance sheet the leased assets are recorded.

For example: The lessor is domiciled in France and the lessee is domiciled in the US.

In France's legal notion of ownership prevails the lessor is recognized as the owner of the asset, thus the lessor is the party on whose balance sheet the assets are recorded. This lessor will be entitled to deduct depreciation which lowering the sum of the profit and, consequently, the cost of the transactions for the US lessee.

Under the tax laws of USA, the transaction will be recognized as a conditional sale contract. Therefore, the lessee company will record the assets on its balance sheet too and will have the right to deduct depreciation. At this circumstances, the "double dip" occurs, which on absolutely legal term, the depreciation of the assets is deducted both in the lessor's and the lessee's countries.

### ***Conclusion***

Cross-border leasing is a highly sophisticated field and there are relatively few firms that have regular practices confined to this niche market. To date, cross-border transactions involving the transit industry that have financed new and used locomotives, aircrafts, railway equipment and automobiles. It is possible that in the future assets such as

telecommunication or typographics, signal and fare collection systems may be financed through cross-border leases.

This type of leasing can be structured to obtain maximum tax benefits by taking advantages of the concessions offered by the tax laws of different countries, which are beneficial for both lessor and lessee. The lessee can get low interest rate on the loan obtained in the lessor's country and the lessors has access to cross country equipment markets for selling the leased equipment.

Even though the parties have some benefits from this leasing structure, the parties may face some possible risk that can cause problems. The parties may face different jurisdiction or different law because their residential are different. Other risks, like the bankruptcy and default of the lessee may be possible risk too.

The most advantage from this structure is double dip taxation where the lessor or the lessee can gain the benefit from tax advantage. Usually it depends on the regulation of the countries.

In summary, cross-border leasing is an asset financing scheme which offers the client the benefits of an ordinary lease transaction and includes the flexibility of structuring the lease rentals to suit the cash flows pattern of the lessee and various tax incentives, among other benefits. However, the disadvantages may cause a problem too but the advantages are more value than the disadvantages.

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